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No. 81-523

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

CONTAINER CORPORATION OF AMERICA,
Appellant,

v.

FRANCHISE TAX BOARD,
Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District

BRIEF OF CITIZENS FOR TAX JUSTICE; AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES; CITIZEN/LABOR ENERGY COALITION; CONSUMER FEDERATION OF AMERICA; INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS; INTERNATIONAL UNION OF OPERATING ENGINEERS; NATIONAL COUNCIL OF SENIOR CITIZENS; AND SERVICE EMPLOYEES INTERNATIONAL UNION: AS *AMICI CURIAE* IN SUPPORT OF THE CALIFORNIA FRANCHISE TAX BOARD

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INTEREST OF AMICI CURIAE

The decision of the Court in this case will affect the right of California, as well as other states, to assess a fair share of the tax burden on multinational corporations. It will therefore directly affect both state and local taxpayers and state and local government workers, since a decision against the State of California in this case is likely to mean increased personal taxes, reduced government services, or both in the states which are affected.

As representatives of middle- and lower-income taxpayers and of state and local government workers, *amici* therefore have a vital interest in the outcome of the case before the Court:

Citizens for Tax Justice (CTJ) is a coalition of national public interest organizations, labor unions, and citizens groups around the country. CTJ was founded in 1979 and is headquartered in Washington, D.C. Through its member organizations, CTJ represents the interests of tens of millions of middle and lower-income taxpayers. Several of CTJ's members also represent state and local government workers around the country, including California.

The American Federation of State, County and Municipal Employees, AFL-CIO, is a national labor organization with approximately one million members throughout the United States and 19,000 members in California.

The Citizen/Labor Energy Coalition (C/LEC) is a national alliance of over 300 labor, senior, neighborhood, environmental and religious groups across the United States. C/LEC was founded in 1978 and is headquartered in Chicago, Illinois. Through its member organizations, C/LEC represents millions of citizens concerned

that multinational energy companies pay a share of taxes commensurate with the benefits received from, and business conducted in, the various states. Many of these citizens live in California.

The Consumer Federation of America (CFA) is composed of approximately 200 national, state and local organizations, including consumer, labor, farm, cooperative and senior citizen groups. CFA was formed in 1968 and is headquartered in Washington, D.C. Altogether, CFA's member organizations represent in excess of thirty million consumers, many of whom are California taxpayers.

The International Association of Machinists and Aerospace Workers, AFL-CIO, is a national labor organization representing approximately 900,000 workers in the airline, aerospace, shipbuilding and auto-related industries and in general manufacturing. Approximately 130,000 of its members are California taxpayers.

The International Union of Operating Engineers, AFL-CIO, is a national labor organization representing 405,000 workers, including operators of heavy equipment in the construction industry and stationary engineers operating plant and equipment in all major industries. It represents 65,000 workers in California, approximately 10,000 of whom are employed by government agencies.

The National Council of Senior Citizens represents approximately 4,000,000 senior citizens in 4,000 local clubs, area and state councils across the United States. Almost 300 of its affiliates are located in California. The National Council of Senior Citizens was founded in 1961 and is headquartered in Washington, D.C.

The Service Employees International Union, AFL-CIO, is a national labor organization representing approximately 675,000 workers in building service, health care,

government and other industries. It has 135,000 members in California, approximately 80,000 of whom work for government agencies.

STATEMENT OF GENERAL CONSENT

This brief is filed with the written consent of both parties, under a general consent on file with the Court, pursuant to Rule 28 of this Court.

SUMMARY OF ARGUMENT

California's application of a three-factor formula to the worldwide profits of unitary businesses is an inherently sensible approach to determining the in-state taxable income of multinational companies which has produced eminently reasonable results on the facts of this case. In fact, it is the alternative, arm's-length method argued by Container to be constitutionally mandated which has the highest potential for inherent arbitrariness and which would lead to the most unreasonable results here.

California's use of the worldwide formula approach no more unconstitutionally undermines the foreign policy of the United States than have Congress's repeated refusals to prohibit the states from using the formula system.

At bottom, the controversy in this case is not a constitutional one. Instead, it is a political dispute. California and several other states seek a fair sharing of their tax burdens and administrable tax systems, while Container and some other multinational firms seek reduced state tax bills. The resolution of this ongoing quarrel should properly be left to the political process.

ARGUMENT

Introduction

The dispute in this case is, on the facts, a narrow one. Container Corporation, a multinational business operating in California, numerous other states, and several foreign countries,[1] contends that California has asserted its tax jurisdiction over approximately one percent more of Container's income in 1963-65 than is permissible under the U.S. Constitution. The amount of California tax in dispute, not counting interest, averages about $24,000 per year—or less than 1/10th of one percent of Container's average pretax income in 1963-65. Put another way, Container seeks a ruling from this Court that California has overstepped constitutional bounds by refusing to reduce Container's state income tax bill by 12 percent.

This narrow factual dispute, however, overlays a far more significant and fundamental issue involving the constitutional power of the states to adopt reasonable measures to determine the in-state taxable income of multinational firms.

Container's specific complaint in this case is with California's inclusion of Container's worldwide income in the base for apportioning taxable income to California under the familiar three-factor, property-payroll-sales formula. Container maintains that the formula should have been applied solely to what Container asserts are its U.S. profits, determined under a separate-accounting, arm's-length approach. In support of its position, Container asserts, first, that its foreign operations do not constitute a "unitary business" with its U.S. operations, and, second, that, even if a unitary business does exist, California's formula approach is "inherently

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[1] Since the tax years in question, Container has itself become a subsidiary of another multinational company, Mobil Corporation.

arbitrary" and has produced results which are "unreasonable" on the facts of this case.

This brief will leave to other participants in the case the task of defending California's treatment of Container as a unitary business. Suffice it to say here that we believe the evidence is overwhelming that the unitary classification is correct. The remainder of the brief will explain why we believe that the California formula applied on a worldwide basis is a reasonable means for California—and other states—to use in measuring the share of a multinational corporation's income properly taxable within the state.[2]

It should be noted at the outset that, while *per force* the appellant in this case is seeking a reduced state tax bill, California's use of the worldwide formula approach is not based on an attempt to tax out-of-state income. As the non-partisan staff of the congressional Joint Tax Committee explained in 1977:

> "the application of the combined reporting [system] does not automatically 'tax' the income of the related corporations whose income, sales, payroll, and property values are taken into account. It only includes all of these items in the apportionment formula, and it may either decrease or increase the taxable income from sources within the State attributed to the corporations. . . . Viewed in this way

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[2] Actually, the questions of whether Container is a unitary business and whether California's formula approach produces a reasonable result substantially overlap. One of the reasons why California's system is appropriate—in fact, necessary—to determine Container's California taxable income is the substantial opportunities for transfers of expertise, good will, borrowing power, technical assistance, and so forth from Container's U.S. operations to its foreign subsidiaries without proper accounting for the costs of these items. Thus, just as a finding of "unitary business" is the "linchpin" of formula apportionment, Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425, 439 (1980), so a finding that formula apportionment is reasonable suggests the existence of a unitary business.

combined reporting is essentially an attempt to define the amount of income properly attributable to each entity and for each taxing jurisdiction." [3]

Container's burden in this case is to show either that "the method of apportionment adopted by [California] was inherently arbitrary, or that its application to this corporation produced an unreasonable result." *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113, 121 (1920). It argues both, but proves neither.

In addition, Container maintains that California, through its use of the worldwide formula approach, and, apparently, Congress, by its repeated failure to prohibit the states from so doing, are unconstitutionally undermining the foreign policy of the United States. This argument, too, has no merit.

I. The facts of this case show that California's determination of Container's California-source income is not "unreasonable," but is instead well within the bounds of "rough approximation."

This Court has stated on numerous occasions that it will find the results under a formula apportionment approach "unreasonable" only "when the taxpayer has proved by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that state,' [*Hans Rees' Sons, Inc.* v. *North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931),] or has 'led to a grossly distorted result,' [*Norfolk & Western Railway Co.* v. *Missouri State Tax Commission*, 390 U.S. 317, 326 (1969)]." *Moorman Manufacturing Co.* v. *Blair*, 437

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[3] *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Senate Comm. on Foreign Relations*, 95th Cong., 1st Sess. 51-52 (1977) (Statement of Paul Oosterhuis, Legislative Council, Joint Committee on Taxation) (emphasis added) [hereinafter *Joint Committee Testimony*].

U.S. 267, 274 (1978).[4] Under these standards, the fact that the dispute in this case is over such a small portion of Container's income would seem to dispose of this factual issue without further investigation.

The California formula apportions a mere one percent more of Container's worldwide income to California than Container claims is correct under the separate-accounting approach it favors. The 12 percent difference between the parties in total apportionment to California must certainly be within the range of "rough approximation" mandated by the constitution, *id.* at 273[5]—whichever method of apportionment is theoretically more accurate.

Which is not to concede—as Container's brief would have the Court assume—that the income allocation produced using a separate-accounting approach is presumptively correct.[6] To the contrary, it is Container's highly touted "arm's-length" standard which leads to the most unreasonable results on the facts of this case. In par-

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[4] *See also* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 227 (1980).

[5] In Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920), Connecticut assessed its corporate tax on 47% of Underwood's net income, based on a single-factor property formula, while the company claimed that only 3% of its profits were actually earned in Connecticut. The Court held that Underwood had failed to prove the formula had produced "an unreasonable result."

In Hans Rees' Sons, Inc, v. North Carolina ex rel. Maxwell, 283 U.S. 123 (1931), the Court had the opportunity to amplify on what an "unreasonable" result might be. It found that clear proof that the formula allocated 83% of the company's income to the state while only 17% was earned there would qualify the taxpayer for relief under the "out of all appropriate proportions" standard. *Id.* at 135. A similarly "grossly distorted result" was found in Norfolk & Western Ry. Co. v. Missouri State Tax Commissioner, 390 U.S. 317, 326 (1968), where the taxpayer made an uncontested case that the state's tax assessment—more than double what the taxpayer claimed to be appropriate—was essentially groundless.

[6] Such a presumption on Container's part, of course, largely begs the factual issue before the Court.

ticular, Container would have the Court find that it earned an average of $1.3 million per year on its Panamanian "operations"—an amount representing over three times the disputed California apportionment in this case—even though it admits that the Panamanian subsidiary was a "non-operating holding company," Jt. App. 30, with no sales, property, payroll, or other business activity.[7]

Container's brief makes much of the argument that California's apportionment formula produces the "ludicrous" result of making it appear that Container paid close to one-hundred percent tax rates in Colombia and the Netherlands in the years in question. But Container fails to acknowledge that its own "separate-accounting" system produces the far more ludicrous result of showing a *357 percent* tax rate in Italy over the same period.[8]

The burden is not on California to show how Container has specifically manipulated the separate-accounting methodology to produce an unacceptable allocation of its income to foreign sources. In fact, the whole point of relying on the formula apportionment approach is to avoid such impossibly difficult questions. But a look at the record provides more than sufficient evidence of the possibilities of such misallocation. In general, Container took advantage of numerous opportunities to share its

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[7] The Panamanian subsidiary was set up in part to avoid U.S. federal taxes, Jt. App. 31. With the advent of Subpart F of the Internal Revenue Code in 1962, I.R.C. §§ 951 *et seq.*, and its subsequent strengthening, this scheme apparently no longer worked, and by 1968 the Panamanian subsidiary had been dissolved. In 1964 and 1965, Container's "Panamanian income" was essentially treated as earned in the United States for federal tax purposes, i.e., foreign "deferral" was disallowed under Subpart F. *See* Jt. App., Exhibits, at 7.

[8] According to Container's separate accounting system, the Italian subsidiaries earned a total of $101,696 in 1963-65, Jt. App., Exhibits, at 1, 3, 5, but Container says these same affiliates paid $363,433 in Italian income taxes, Jt. App. 84.

good will, borrowing power, expertise, and so forth with its foreign subsidiaries, often apparently at no charge. Of course, there is nothing wrong with Container helping its subsidiaries earn higher profits; in fact, such is to be expected of a unitary, integrated business. But when the costs of such assistance are assigned to the U.S. rather than overseas, the result is a misallocation of reported income.[9]

Some examples: Container made or guaranteed over half the loans received by its foreign subsidiaries, Jt.

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[9] The Treasury Department has described the general nature of the tax avoidance opportunities available to U.S. multinationals as follows:

> "U.S. taxpayers have many opportunities to avoid U.S. taxes by engaging in various pricing and other practices in transactions with their controlled foreign corporations. A multinational enterprise routinely engages in many transactions with its foreign affiliates. It often sells machinery, parts, components, and finished goods to these foreign corporations . . . . It lends them money, leases them equipment, and provides a wide range of managerial services. Basic research and development programs for the mutual benefit of the domestic taxpayer and its foreign affiliates are often centralized in the United States. In computing foreign and domestic tax liabilities, a company must assign transfer prices to such inter-affiliate transactions. . . . Although many multinational companies follow perfectly acceptable transfer pricing practices, the experience of the Internal Revenue Service has been that some do not, and the resultant loss of U.S. tax revenues can be substantial."

U.S. Dept. of the Treasury, THE PRESIDENT'S 1978 TAX PROGRAM 286-87 (Jan. 30, 1978), printed in *The President's 1978 Tax Reduction and Reform Proposals: Hearings before the House Comm. on Ways and Means*, 95th Cong., 2d Sess. 160, 442-43 (1978) [hereinafter *Treasury Testimony*, with citations to the Ways and Means hearing record]. A similar description of the tax avoidance/evasion opportunities available to multinational firms can be found in Comptroller General, IRS COULD BETTER PROTECT U.S. TAX INTERESTS IN DETERMINING THE INCOME OF MULTINATIONAL COMPANIES, REPORT TO THE CHAIRMAN, HOUSE COMMITTEE ON WAYS AND MEANS 1-2 (1981) [hereinafter *GAO Report*].

App. 70. Each percentage point reduction in the interest rate paid by the subsidiaries would misallocate about $114,000 per year in net income to them.[10] Container also brokered, at a bargain rate, some 90 percent of the equipment purchases by the Latin American subsidiaries, Jt. App. 77, which could have been worth about $300,000 a year to the subsidiaries. Technical assistance to the Colombian and Venezuelan subsidiaries often went unreimbursed, Jt. App. 74-75, and based on the technical assistance fees paid by other subsidiaries, this aid may have been worth at least $400,000 per year. Container made direct sales of equipment to subsidiaries, apparently at below market prices in the years in question, Jt. App. 76-77, which may have saved the subsidiaries significant amounts. Container's sales of materials and stock in trade, at alleged arm's-length prices, averaged over $1 million per year, Jt. App., Exhibits, at 8.[11] Container shared its U.S. good will with the subsidiaries, by recommending them to its U.S. customers for overseas work, Jt. App. 32-33, apparently at no charge. Container's $4.3-5.5 million in annual product, design, and marketing research, Jt. App. 27, was made freely available to the subsidiaries

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[10] The total outstanding loan advances from Container to its foreign subsidiaries in the years at issue averaged $6,028,000. Total outside loans outstanding averaged $16,178,000, of which Container "guaranteed approximately one third," or about $5,393,000. Thus, the total of loans made or guaranteed by Container to the subsidiaries averaged approximately $11,421,000, or 51.4% of total outstanding loans. *See* Jt. App. 69-70. Each percentage point difference in the interest rate would therefore be worth about $114,000 per year. During the years in question, the IRS had no standards for evaluating such inter-affiliate loans. Under rules established in 1968, however, the minimum "safe-haven" interest rate for such loans averaged over 4 percentage points below the U.S. prime rate from 1968 to 1980. *See GAO Report, supra* note 9, at 16.

[11] Container tries to belittle these purchases of materials by pointing out that they were only a small percentage of total cost of goods sold. That fact is not dispositive or even important, however. After all, taxable profits are generally only a relatively small percentage of costs or sales, too.

when appropriate, as were samples of products, Jt. App. 33-35. Subsidiaries were assisted in setting up their own design laboratories, again taking advantage of Container's expertise, Jt. App. 35. Container helped with personnel management, Jt. App. 48, 50, 60-62, and applied its expertise to evaluate all major capital spending decisions, Jt. App. 39. It trained foreign employees in the U.S., Jt. App. 69. And so on and so on. The total value of these and other benefits provided to affiliates without proper reimbursement could easily exceed the approximately $3.9 million a year at issue between U.S. and foreign apportionment, not to mention the $2.6 million at issue if "Panamanian income" is excluded.

Container's brief makes several detailed economic arguments contending that California's formula apportionment system produces incorrect results in specific situations. All these arguments are interesting; none of them is convincing.[12] But most important, such economic the-

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[12] For example, Container devotes a significant portion of its brief to the contention that California's formula fails to take account of different levels of profitability in foreign versus domestic operations. Foreign operations, says Container, are generally more profitable because they are riskier. For evidence of this economically rather puzzling contention, it points to the testimony of a witness who, extrapolating from several studies of the U.S. stock and bond markets, suggested that "there is a profitability of foreign operations, across all countries, on average, over time, very often larger than that on the domestic operation." Jt. App. 148 (apparent transcription errors have been corrected). If this heavily qualified assertion is supposed to mean that corporate rates of return are lower in the U.S. than abroad, it would surprise most foreign corporate executives, since U.S. corporate profitability has generally been substantially higher than that of foreign firms. Compare, for example, *International Corporate Scoreboard*, BUSINESS WEEK, July 20, 1981, pp. 86 *et seq.* (showing for foreign-based firms an average return on equity of 11.7% and an average return on sales of 3.0%) with *Corporate Scoreboard*, BUSINESS WEEK, March 16, 1981, pp. 65 *et seq.* (showing for U.S. based firms an average return on equity of 15.3% and an average return on sales of 9.0%). It might also surprise the Treasury Department. One of Treasury's

orizing has no place before this Court. Even absent the staggering caseload burden faced by the Court, it is not appropriate for this Court to be asked to pore over financial statements and evaluate various economic theories every time a corporate taxpayer disputes a state's apportionment of its taxable income by a few percentage points.

II. Formula apportionment of the worldwide income of unitary businesses is an appropriate means for the states to determine the in-state income of multinational firms.

Container argues that formula apportionment of worldwide unitary income is always "inherently arbitrary." It contends that the *only* allowable method is the arm's-length, separate-accounting system. The question before the Court, then, is whether the arm's-length approach is so clearly correct and so clearly superior to the formula approach that the states are constitutionally required to use it. The answer to this question is no.

Container's panegyrical view of the arm's-length method is shared by few, if any, analysts who have studied the IRS efforts to utilize that approach under section 482 of the Internal Revenue Code. For example, a 1981 General Accounting Office (GAO) report found:

> "Representatives of all groups affected by and knowledgeable about section 482 enforcement under the arm's length standard have voiced continuous and substantive criticism of the regulations. The criticisms focus on the fact that section 482 enforcement creates a large administrative burden and that

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criteria for choosing which multinational firms to audit under its arm's-length approach is: "Consolidated worldwide profits [i.e., profitability] are higher than U.S. profits. This type of situation can be an indication that profits of the U.S. corporations are being diverted to a tax haven country." *GAO Report, supra* note 9, at 37.

> the end result . . . is too often unpredictable and subjective." [13]

After reviewing the years of effort by the Treasury in attempting to improve enforcement under the arm's-length standard, the GAO report concluded as follows:

> "*RECOMMENDATION TO THE SECRETARY OF THE TREASURY.* We recommend that the Secretary of the Treasury initiate a study to identify and evaluate the feasibility of ways to allocate income under Section 482, *including formula apportionment*, which would lessen the present uncertainty and administrative burden created by the existing regulations." [14]

We would be remiss not to point out that this recommendation elicited criticism from the Treasury Department, which wrote that, while "the arm's-length principle may have both conceptual and practical limitations in a world of integrated firms selling differentiated products," "[i]n terms of economic rationale, formula apportionment has little merit" as well.[15] As Container suggests in its brief, Treasury has traditionally criticized the formula apportionment method in its written statements.[16] But GAO's conclusion recommending reconsideration of a federal formula approach was based largely on Treasury's own statements about the terrible problems it has encountered in attempting to enforce the arm's-length system.

The GAO report quotes a former Deputy Assistant Treasury Secretary as lamenting how "impossible" it is to achieve better than "a rough and unproven estimate" of proper cost allocation under the arm's-length system.[17]

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[13] *GAO Report, supra* note 9, at 43.

[14] *Id.* at 53-54 (emphasis added).

[15] *Id.* at 93, 95.

[16] *See* Brief of Appellant, at 29-34.

[17] *GAO Report, supra* note 9, at 48.

Similarly, in 1978 the Treasury Department complained to Congress about the "substantial" revenue loss to the federal government which results from IRS's inability to police the arm's-length standard effectively, and noted:

> "Of course, extensive Regulations setting forth procedures for determining arm's-length transfer prices were published in 1968, and have limited the range of discretion previously available to taxpayers. *But no one familiar with international tax planning believes that the Regulations have taken the tax incentive out of transfer pricing.*" [18]

As Treasury's 1978 statement notes, for the tax years at issue in this case, there were not even detailed regulations at the federal level to enforce the arm's-length standard.[19] But more important, the issuance of these regulations has not stemmed the frustration with section 482 and arm's-length, separate accounting or the criticisms of the inefficiency of tax enforcement under that approach.

Actions may speak louder than words, and, in fact, despite its protests to the contrary, Treasury typically has been unable to utilize a purely arm's-length approach in its own enforcement of the tax laws with regard to multinational companies—and instead has been moving away from the arm's-length approach to a significant degree. The 1981 GAO report found that "only 3 percent of the . . . IRS recommended section 482 adjustments [in the cases covered by the GAO study] were based on arm's length prices determined through uncontrolled transactions." [20] Twenty-two percent of the adjusted amounts were based on "safe-haven" rules which may

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[18] *Treasury Testimony, supra* note 9, at 443 (emphasis added).

[19] The 1981 GAO report explains that the IRS had little need for detailed regulations, "because it seldom used" section 482. *GAO Report, supra* note 9, at 3.

[20] *Id.* at 29.

have little or no relation to arm's-length pricing.[21] And two-thirds of the amounts adjusted were based on "alternative techniques," including such things as assigning an assumed profit margins to labor costs or sales.[22]

While some have quibbled with GAO's exact statistics,[23] there is little doubt that in a large proportion of the federal section 482 cases the information necessary to determine true arm's-length transfer prices has been unavailable, and "IRS agents and the courts have been left to determine the proper allocation on whatever ad hoc basis seems appropriate." [24] Faced with these difficulties, Treasury has been attempting to move toward the increased use of formulas and rules of thumb in international tax enforcement. Most notably, in 1977 Treasury issued new rules for apportioning corporate overhead, research and development costs, and interest expenses between domestic and foreign sources under section 861 of the Internal Revenue Code, a cousin of section 482. The centerpiece of the new rules is a series of formula apportionments, based on sales and assets.[25]

The complaints about the defects of the arm's-length allocation system have not been limited to the grumblings of tax collectors. Corporate taxpayers also have been extremely critical of IRS enforcement under section 482—and not merely of IRS techniques, but of the basic arm's-length philosophy. The GAO report cites a 1980 business survey which found that:

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[21] *Id.* at 29. As noted *supra*, for example, the "safe haven" interest rate has been well below the U.S. prime rate. *Id.* at 16.

[22] *Id.* at 29-32.

[23] *See id.* at 33, 83.

[24] *Joint Committee Testimony, supra* note 3 at 52.

[25] Treas. Regs. § 1-861-8. *See* 42 FED. REG. 1195 *et seq.* (Jan. 6, 1977) for the rules and the Treasury explanation of their formula approach.

> "Although [multinational firms are] composed of numerous legally separate entities, [a majority of the executives of such firms offering an opinion] reveal that their companies make most intercompany pricing decisions as though the organization is one economic unit. *This basic difference in philosophy between the IRS and multinational corporations is central to the Section 482 controversy.*" [26]

More specifically, reports the GAO, corporate officials have called outcomes under section 482 "arbitrary," and have complained that "the analytical approach to determining arm's length prices often leads to unreasonable results." [27]

"Arbitrary" and "unreasonable." The striking similarity between these business criticisms of the arm's-length method and the complaints Container and its corporate *amici* are now making about California's formula approach suggests that something less than principle may be at work here. That suspicion is strengthened by the praise in Container's brief for the formula approach employed under the section 861 source rules,[28] which several

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[26] Burns, *How IRS applies the intercompany pricing rules of Section 482: A corporate survey*, 52 J. TAX. 308, 314 (May 1980) (emphasis added), paraphrased in the *GAO Report*, *supra* note 9, at 45. The surveyed executives agreed with the quoted statement by a 49-41 percent margin, with 10 percent undecided. The Burns study also found that "[w]hile most [executives] seem to accept the basic arm's-length premise," 52 J. TAX., at 313, this acceptance went only so far as favoring a system of transfer pricing. In setting those transfer prices, most opposed a true arm's-length approach and favored instead such things as cost-plus pricing, safe-haven rules, profit splitting based on formulas, or other formula approaches. *Id.* at 309, 313.

[27] *GAO Report*, *supra* note 9, at 44.

[28] *See* Brief of Appellant, at 30-31.

commentators have criticized as too generous to multinational firms.[29]

No one who has studied this complex area of the tax laws in depth could honestly argue to this Court that the formula approach to apportioning multinational corporate income achieves perfect results in all instances.[30] But it is equally clear that the arm's-length approach is not the panacea Container claims it to be. The staff of the congressional Joint Committee on Taxation has summarized the views of international tax experts on the arm's-length versus formula apportionment issue as follows:

> "Given the problems which exist with the States' methods of apportionment under combined reporting and with the Federal Government's allocation rules, there is considerable disagreement as to which method is preferable in various situations." [31]

In fact, the large number of distinguished commentators who have argued in favor of the formula approach on a worldwide basis should by itself resolve this issue in California's favor. While reasonable minds, can, of

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[29] *See, e.g.*, M.J. McIntyre, *An Inquiry Into the Special Status of Interest Payments*, 1981 DUKE L. J. 765, 806 n. 132 (1981) ("The Treasury's source rule also contained many special rules that can only be explained as concessions to political exigencies."); Tax Reform Research Group, Comments on Proposed Regulations Dealing with Allocation and Apportionment of Deductions Between Domestic and Foreign Source Gross Income, Dec. 16, 1976 (unpublished comments submitted to the Treasury Department).

[30] In fact, California allows companies which feel that the formula produces unreasonable results to challenge those results in administrative proceedings, on a case-by-case basis. *See* section 25137 of the California Revenue and Taxation Code. The same provision for modification of formula apportionment on a case-by-case basis is contained in section 19 of the Uniform Division of Income for Tax Purposes Act, which has been adopted by 25 states and the District of Columbia.

[31] *Joint Committee Testimony, supra* note 3, at 52.

course, differ on the question of the "best" approach to apportioning the income of multinational firms, California has clearly chosen an approach which is by no means "inherently arbitrary"—either in theory or in the minds of numerous experts.[32]

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[32] *See, e.g.*, Harley, *International Division of the Income Tax Base of Multinational Enterprise: An Overview*, TAX NOTES, Dec. 28, 1981, at 1563, 1567 (Based on "a measured evaluation" of the arm's-length versus the formula approach to allocating multinational corporate income, "the formula approach is the better one. Perhaps the underlying reason for its superiority is that the formula approach makes no claims to achieve a perfect result. It recognizes, rather, that a perfect allocation is impossible, The unitary system seeks a reasonable division of income by formula. The arm's-length standard strives for reasonable accuracy, but it fails to achieve it, and its theoretical basis is unsound,"); P. Musgrave, *The U.K. Treaty Debate: Some Lessons for the Future*, TAX NOTES, July 10, 1978, at 27, 28 ("Proponents . . . [have] suggested that the arm's-length separate-accounting method is inherently closer to establishing the true source of profits and therefore is less arbitrary than the unitary approach. Such is far from the case. . . . The use of the unitary method as implemented by a factor formula is not perfect, but it places less of a burden on administrative resources than does enforcement of the separate-accounting-arm's-length approach. . . . [T]here is less danger of base slippage and discretionary profit shifting on the part of the taxpayer and there are fewer items which have to be audited and checked."); Dexter, *The Unitary Concept in State Income Taxation of Multistate-Multinational Businesses*, 10 URBAN LAWYER 181, 183 (1978) ("the [unitary] concept, in my view, . . . is required to determine properly the portion of a tax base reasonably attributable to a taxing state."); Comment, *Multinational Corporation and Income Allocation Under Section 482 of the Internal Revenue Code*, 89 HARV. L. REV. 1202, 1228 (1976) ("The unitary entity theory has certain clear advantages. Principal among these is its theoretical superiority as a means for ascertaining the true income of various MNC [multinational corporation] components."); Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 TAX L. REV. 171, 207-08 (1970) ("section 482 type adjustments do not appear to provide a satisfactory alternative to combined reporting. . . . It is, of course, the inadequacy of separate accounting . . . that provides the underlying rationale for formulary apportionment."

III. California is not unconstitutionally undermining the foreign policy of the United States by its use of worldwide formula apportionment, nor has Congress violated the constitution by its repeated refusals to restrict the power of the states to use the worldwide formula approach.

Container's final attack on worldwide formula apportionment consists of the contention that California is unconstitutionally subverting the foreign policy of the United States by failing to follow the IRS regulations on income allocation. Logically, this argument would seem to apply equally to the U.S. Congress for its refusal to prohibit the states from using the worldwide combination approach in taxing multinational companies. And, in fact, Container rehearses the same arguments it and others have made to the Congress in this regard, arguments which the Senate explicitly rejected when it stripped a restriction on state use of worldwide combination from a proposed tax treaty with the United Kingdom in 1978 and which the full Congress has repeatedly rebuffed for over 20 years by refusing to enact proposed legislation to restrict state formula apportionment powers.[33]

As Container's brief admits, the standard to be applied in resolving this issue is whether California's action and Congress' considered inaction "stand[] as an obstacle to

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[33] In 1978, the Senate refused to ratify the proposed tax treaty with the United Kingdom until a restriction on the states' use of the worldwide combination method with regard to foreign multinationals was deleted. In so doing, the Senate explicitly rejected contentions by the Treasury Department that such a restriction was appropriate to avoid "disconcerting . . . international relations." *Tax Treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines, Hearings before the Sen. Comm. on Foreign Relations,* 95th Cong., 1st Sess. 28 (1977). Since 1965, bills dealing with state taxation of multistate and multinational corporations have been introduced in every session of Congress, but none has been enacted.

the accomplishment and execution of the full purposes and objectives of Congress." *Hines* v. *Davidowitz*, 312 U.S. 52, 67 (1941).[34] Merely to state the question clearly is to resolve it in California's favor. Beyond peradventure, Congress does not believe its "purposes and objectives" are contravened by California's use of worldwide formula apportionment. This Court has no need to protect Congress from a danger our legislators, after careful deliberation, have found insufficient to justify national interference with the sovereign taxing powers of the states.[35]

IV. The decision of how to measure the in-state income of multinational firms is a political question which the constitution leaves to the states and (perhaps) to the Congress.

The implicit assertion throughout Container's brief is that a decision in favor of California in this case would leave the states with unbridled power to tap unfairly the "deep pockets" of multinational firms. This is simply not the case, for a number of reasons.

First of all, the formula approach produces generally fair results—in the opinion of a great number of experts, the fairest results attainable given the complexities of international business transactions. Second, companies always have the option to move their operations outside a state's borders if they find its tax regime intolerable, a threat which they have used to great advantage in

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[34] *See* Brief of Appellant, at 35.

[35] Container's attempted reliance on Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979), is misplaced. That case involved a county tax on *instrumentalities* of foreign commerce which by treaty were exempted from federal taxes and customs duties under a policy which the Court found would be clearly undermined by state taxation. The dispute in the instant case, on the other hand, is over the *measurement of income* from various sources, and Congress has repeatedly refused to restrict state use of measurement techniques different from those spelled out in IRS regulations.

garnering a vast array of state and local tax breaks over the years.[36] Few, if any, states can be expected to adopt tax approaches which demonstrably drive businesses and jobs away. In this light, the fact that there has been no rush by multinational firms away from California, but instead a steady movement into the state, provides further evidence that the formula apportionment approach does not produce unfair results.[37] And finally, Container and its allies can always petition the U.S. Congress for relief—although we do not believe Congress should grant it.[38] In fact, multinational companies have brought this

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[36] *See, e.g.*, J. Jacobs, BIDDING FOR BUSINESS: CORPORATE AUCTIONS AND THE 50 DISUNITED STATES. (1979).

[37] Most notably, California even leads the country in attracting investment by *foreign-based* multinationals, despite the fact that many of them, by locating in California, may subject themselves to taxation based on formula apportionment of their worldwide income. According to reports published by the U.S. Census Bureau, California leads the nation in the number of foreign-owned firms with two or more establishments and has widened its lead over other states since the Bureau began its series of reports in 1975. In 1980, the last year for which data are available, California had 4,829 such foreign-owned establishments (1,130 more than second-place New York), compared to 1,999 in 1975 (325 more than second-place Ohio). U.S. Dept. of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1980, Table 6 (1982); U.S. Dept. of Commerce, Bureau of the Census, SELECTED CHARACTERISTICS OF FOREIGN-OWNED U.S. FIRMS: 1975-1976, Table 7 (1979).

[38] As this Court stated in Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280 (1978) (*dicta*):

> "It is clear that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all States to adhere to uniform rules for the division of income. It is to that body, and not this Court, that the Constitution has committed such policy decisions."

At least one congressional analyst has contended that even Congress may lack power to interfere with the states' taxing power by restricting worldwide formula apportionment. In a paper prepared in

issue repeatedly before Congress, and have been repeatedly rebuffed.

At bottom, the arm's-length versus formula apportionment controversy is not a constitutional question. It is a political issue, in which states are attempting to protect their tax bases and some multinational firms are seeking to lower their tax bills.

Quite naturally, corporate taxpayers, like most natural citizens, prefer to pay as little in taxes as possible. Accordingly, companies pursue every opportunity to create legal devices which allow them to escape taxation of their income.[39] Every dollar of legitimate taxation they are able to avoid, however, is a dollar which must be paid for by other taxpayers, either in increased taxes or reduced services. Particularly in the states, where balanced budgets generally are constitutionally mandated, tax avoidance imposes a heavy cost.

1978, Archie Parnell, Senior Staff Counsel to the Ways and Means Oversight Subcommittee, together with William L. Shraberg, a trial attorney with the Tax Division of the Justice Department, Gloria Dunbar, and Abbe Jolles, argued that "a court could conclude that a state, as a sovereign entity under our federal system, as long as a non-discriminatory state income tax does not violate the Commerce Clause, is free to structure its taxes in any manner it chooses. Such a conclusion would necessarily mean that [a restriction on the use of worldwide formula apportionment] would be found to be unconstitutional." Parnell, Shraberg, Dunbar, & Jolles, *Article 9(4) and the Constitution*, TAX NOTES, July 10, 1978, at 29.

[39] A 1980 study, for example, calculated that in 1980 the 23 largest oil companies would fail to report to state tax departments almost half the domestic profits they reported to the federal government. The estimated unreported income totalled $9.7 billion, resulting in a state revenue loss of over $450 million. The study blamed the failure by state governments to detect this underreporting largely on the use by a large number of states of a separate-accounting approach to allocating interstate income. Citizen/Labor Energy Coalition, *Where Have All The Profits Gone: A Study of State Undertaxation of the Oil Industry* (Washington, D.C. 1980) (mimeographed copy).

The states therefore have good reason to try to assure that their tax laws are effectively enforced. California, along with a number of other states, has concluded that adoption of the arm's-length approach would mean ceding its tax jurisdiction over multinational firms to the vagaries of federal enforcement under section 482 of the Internal Revenue Code.[40] California reasonably believes it can obtain the most accurate measurement of the taxable income earned in California by multinational firms such as Container through the use of a simple, fair, and administrable system of worldwide combined apportionment—a belief sustained by the well-documented shortcomings of the arm's-length methodology and the strong expert support for the formula approach.

California's preference for formula apportionment is a political choice as to the best way fairly to share its tax burden and protect its average individual and business taxpayers. It is no less a political choice than was its decision in 1972 to institute a system of tax withholding and declaration of estimated taxes. Nor is it any less political than the decision of states like Nevada and Texas to impose no corporate income tax at all or the choice of states such as Connecticut and Florida to impose corporate, but not personal, income taxes.

Having failed to overturn California's formula approach through the political process, Container and its

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[40] California's adoption of the federal allocation system would also apparently make it vulnerable to the vagaries of congressional "tax incentive" policies. In 1981, for example, Congress directed Treasury to modify at least temporarily its source rules under section 861 of the Internal Revenue Code, so that "the expenses related to all research activities conducted in the United States should be charged to the cost of generating U.S. source income, whether or not such research directly or indirectly is a cost of producing foreign source income." Staff of the Joint Committee on Taxation, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 142 (1981). The reason offered for the action was to try to encourage research activities in the United States. *Id.*

allies have now brought the issue before this Court. Their challenge, masquerading as constitutional, is actually a political one. It should be rejected.

CONCLUSION

For the foregoing reasons, we urge the Court to affirm the judgment of the court below.

Respectfully submitted,

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